Financial Systems & Regulation

How prepared are European banks to comply with MREL?

The importance of the subordination requirement

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Executive Summary

- The Minimum Requirement for own funds and Eligible Liabilities (MREL) is a requisite for EU banks which was introduced in the EU through the Bank Recovery and Resolution Directive (BRRD) in 2014 to ensure the effective implementation of the bail-in tool, i.e. that shareholders and creditors are the first to absorb losses when a bank fails. The bail-in tool represents the cornerstone of the BRRD.
- MREL is only a few years old, however its principal aspects are now under revision by EU legislators in the context of the banking reform package, expected to be approved by end 2018 - beginning 2019.
- The subordination requirement is one of the most significant amendments that will be introduced in the MREL framework. It will set how much of the MREL requirement will have to be met with subordinated liabilities (those ranking below traditional senior debt). So far, European authorities agree on the MREL formula, but not on subordination.
- Based on data from end 2017 we have estimated the shortfall of MREL under three different scenarios with increasing levels of subordination for a heterogeneous sample of 63 European banks. The results show that the overall deficit of MREL for this sample of banks is **€ 195 bn** under **the subordination recommended by the EBA** (light scenario), **€ 301 bn** under the **Council's compromise text subordination** (medium scenario) and **€ 526 bn** under a **full subordination** scenario (hard scenario), which is the scenario where banks would have to comply with MREL with subordinated liabilities only. Therefore, the debate on subordination is a critical aspect for European banks, as it has an overwhelming impact in quantitative terms.
- Similarly, subordinated instruments shortfall would be **€ 24 bn** under the light scenario, **€ 167 bn** under the medium scenario and **€ 526 bn** under the hard scenario.
- **Banks from peripheral[1] countries would display the greatest MREL shortfalls** in percentage points (pp) of risk-weighted assets (3.7% in the light scenario, 4.4% in the medium one and 6.4% in the hardest). Particularly, the most affected countries would be Greece (10%), Portugal (6%-9%), Ireland (5%-7%) and Spain (4%-6%).
- **Banks from core countries would manage relatively limited shortfalls** in pp of risk-weighted assets. However, core countries' MREL shortfalls increase more rapidly under more stringent subordination scenarios.
- The heterogeneity observed in shortfall levels among banks and countries is derived from the fact that some financial systems and some banks within those systems rely to a greater extent on senior debt for their funding, while others (mainly peripheral countries and smaller less diversified banks) tend to focus on the issuance of subordinated instruments (mainly regulatory capital) and deposits as their main source of funding.

[1] Peripheral countries are Greece, Italy, Ireland, Portugal and Spain, while core countries are Germany, Austria, Belgium, France and the Netherlands.

- The **European market of MREL-eligible debt is highly fragmented**, with 58% of the outstanding balance concentrated in core countries and 12% in peripheral ones[2] (data as of June 2018) with greater fragmentation observed in senior preferred debt (68% core vs 10% peripheral).
- Banks from peripheral countries only account for 11% of senior unsecured issuances, but they accumulate 31% and 44% of subordinated debt and Contingent Convertibles or AT1 (CoCo) issuances, respectively. Peripheral countries face issuance costs above the average for both senior and subordinated instruments. This, coupled with the fact that they also display the largest shortfalls, means **that complying with MREL will prove to be more challenging for banks from peripheral countries.**

Objectives and main assumptions

Objectives

The objective of this report is to estimate the shortfall of MREL for a sample of European banks under different scenarios in which the subordination requirement plays a key role. The banking reform package proposed by the EU Commission in November 2016 is currently under the “trilogues” phase, which is the last step in the legislative process. Among other things, this package introduces TLAC in the EU but also changes many aspects of MREL by modifying the BRRD, the CRDIV, the SRMR and the CRR. One of the most important amendments and which is the subject of intense negotiations in the EU Council and the European Parliament is the subordination requirement.

This note takes into account the different proposals that are now being discussed in order to assess their impact on a sample of European banks. The main objective of this exercise is to identify which countries are most affected by MREL depending on the level of subordination required. The note also analyzes the recent evolution of banks’ debt markets.

Sample

For the purposes of this note, we have considered a heterogeneous sample of 63 banks[3], representing approximately 82% of European banks’ assets, with data as of December 2017. The sample includes all EU G-SIIs, thirty eight O-SIIs and thirteen other banks. Among the 63 banks of the sample, 45 are considered *top tier banks, i.e. those* with a consolidated balance sheet above € 100 bn[4].

MREL requirements

First of all, we have calculated MREL on a consolidated basis[5] and assuming that all banks in the sample will follow a bail-in strategy, i.e. that they will comply with a “full” MREL divided into loss absorption (P1 + P2R), recapitalization (P1 + P2R), and market confidence (CBR – CCyB) components. The formula used to calculate MREL requirement is the one provided in both the Council’s and the Parliament’s compromise texts (see far right shape on Figure 1): [2 * (P1 + P2R) + CBR – CCyB] * RWA. This formula is not definitive and is not binding yet but

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2 Core countries represent 46% of the assets of the sample considered while peripheral represent 18% as of December 2017. Core countries have a higher share (lower for peripherals) of eligible instruments than their total market share measured in terms of total assets.
3: 61 EU banks and 2 Norwegian banks.
4: As per the definition of *top tier bank* found in the Council’s compromise text of May 2018. Subordination is mandatory for top tier banks.
5: That is, we have not taken into account the differences between Single Point of Entry (SPE) and Multiple Point of Entry (MPE) banks. The latter are subject to MREL at sub-consolidated level (at resolution entity level). But because of limitations in public information we have calculated MREL at consolidated level only, as if all banks in the sample followed an SPE strategy.

will most likely be the basis for the calculation of MREL in the near future given the high level of consensus between the EU co-legislators[6].

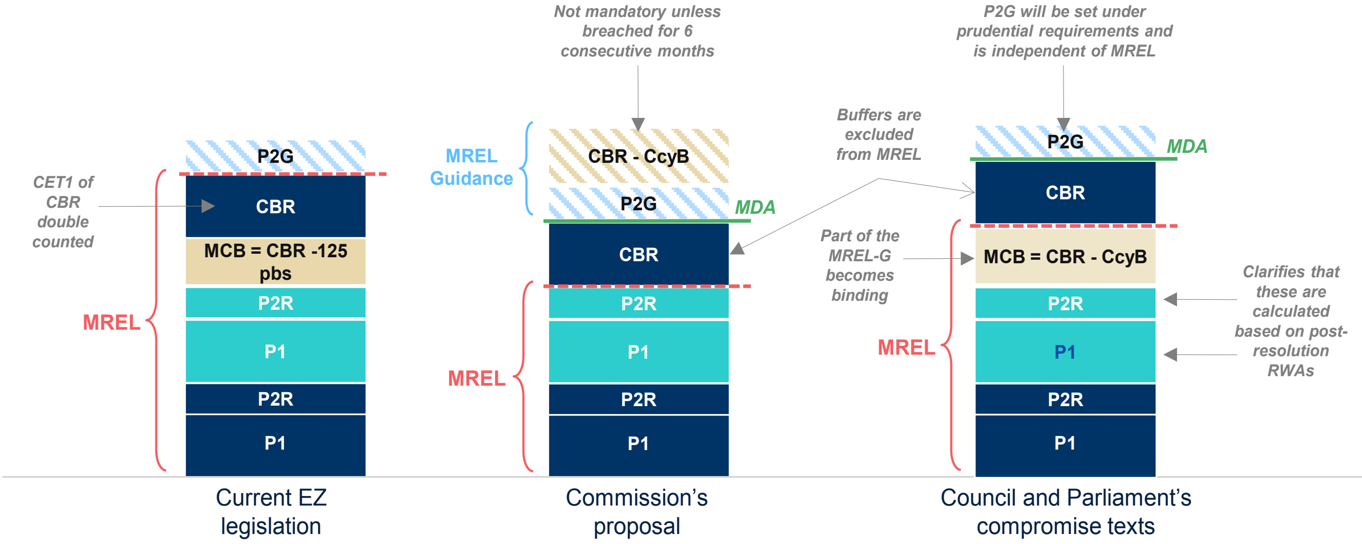
We have also used a "floor" benchmark equal to 8% of total liabilities and own funds (TLOF[7]) when the result of the above mentioned formula is lower than 8% of TLOF. Indeed, the Single Resolution Board (SRB) has repeatedly stated that it would use that benchmark[8] in order to set MREL. Furthermore, the Council's compromise text includes a new minimum subordination requirement equal to 8% of TLOF, which implicitly means that the calibration of MREL would at least reach that level.

The formula differs from the one provided in the current Eurozone legislation in the sense that CET1 cannot be double counted towards both the buffers and MREL and that there is no "one size fits all" downwards adjustment to the recapitalization component of MREL of 125 bps. It is also more stringent than the initial Commission's proposal because the requirement has been increased by a market confidence buffer equal to the combined buffer (CBR) minus the countercyclical buffer (CcyB; the Commission included this as part of the MREL Guidance, which was not a mandatory requisite).

In order to estimate the maximum impact, we have not applied any additional downward adjustments (for example, because of balance sheet depletion or from the use of recovery options) to the recapitalization part of MREL. Although these continue to be allowed under the Council and the Parliament texts we assume they will not be significant for the banks under our sample.

Finally, we have assumed that banks will have to comply with their Pillar 2 Guidance (P2G) with CET1. For those that do not disclose that figure (the majority of them, as its disclosure is not mandatory) we have assumed that P2G is equal to 1% of their RWAs.

Figure 1 Comparison of different MREL formulas



Source: BBVA Research

6 The Parliament and the Council's texts are part of the negotiation of the banking reform package published by the Commission in November 2016 with amendments to the CRR, CRDIV, BRRD and SRMR. As of today, the texts are not binding as the legislative process has not concluded yet. They still need to be finalized during the "trilogue" phase during which a consensus must be reached between the Commission, the Parliament and the Council. The definitive texts are not expected before end 2018. They will be binding once the Directives are transposed into national law and once the foreseen transition periods are over (in the case of regulations).
7 For simplicity purposes and because of a lack of limitations in public information we have used total assets as a proxy.
8 Which in the current BRRD is the minimum bail-in required before the use of resolution funds.

Subordination scenarios

Unlike the formula to calculate MREL, the subordination requirement has not reached the same level of agreement between the Council and the Parliament. In fact, the positions of the co-legislators are very far apart and the subordination requirement is proving to be one of the most controversial issues in the negotiation of the banking reform package. Whereas the Council supports a tougher stance compared to the initial Commission's proposal, the Parliament tries to maintain a level playing field for banks in the EU by sticking to international principles[9].

In order to compare the different proposals on the table and their impact on EU banks, we have included three different scenarios in our exercise:

1. A "light" scenario based on the recommendations of the EBA in its final report on MREL[10] and similar to that proposed by the Parliament, that is, a minimum subordination requirement of 14,5% of RWAs for G-SIIs; 13,5% of RWAs for O-SIIs and no requirement for the rest of the banks.
2. A "medium" scenario based on the Council's minimum subordination requirement of 8% of TLOF (with an allowance to compute certain non-subordinated instruments).
3. And a "hard" scenario with full subordination, also based on some eventualities considered in the Council's text[11], in which all banks in our sample would have to comply with MREL using subordinated instruments only without any allowance to compute instruments such as senior preferred debt.

MREL-eligible instruments

We have considered the following instruments as eligible towards the MREL requirement:

- CET1 which is not already used to cover other requirements such as the combined buffer or P2G
- AT1
- Tier 2
- Other subordinated debt not considered as regulatory capital
- Senior non preferred debt (i.e. contractually subordinated debt) or senior debt issued from a holding company (i.e. structurally subordinated, a model which is predominant in Anglo-Saxon and certain Dutch banks).
- Traditional or senior preferred debt and also structured notes (depending on the subordination scenario).
- We have excluded uncovered non-preferred deposits (such as those from credit institutions, collective investment undertakings, pension funds, etc.)[12]

We have not taken into account whether eligible liabilities comply with the new requirements of the amended CRR as we see a high probability[13] that those issuances will be grandfathered until their maturity and will thus be able to be computed towards MREL. Moreover, we have not taken into account the requisites of art. 55 of the BRRD whereas liabilities governed by third country law (UK issuances will probably acquire that status) need to include a bail-in clause in order to be MREL-eligible. We have assumed that all liabilities regardless of their governing law

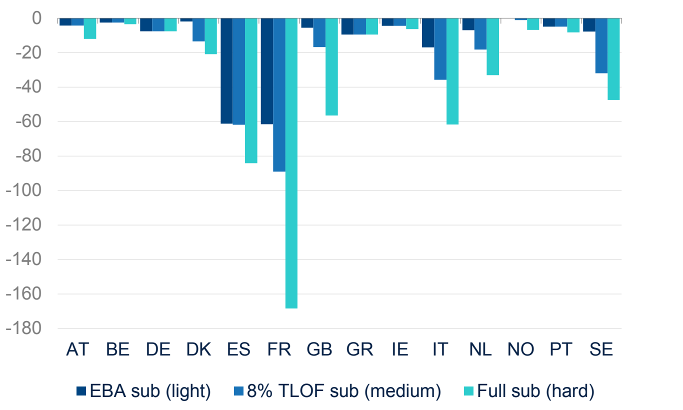
9: The Parliament's version of the subordination requirement is similar to that found in the FSB's TLAC Term sheet albeit its scope is expanded to include banks other than G-SIIs.
10: https://www.eba.europa.eu/documents/10180/1695288/EBA+Final+MREL+Report+%28EBA-Op-2016-21%29.pdf
11: The Council's text sets 8% of TLOF as a minimum level of subordination for top tier banks. However, that level may be increased to match the MREL formula (i.e. MREL should be complied with subordinated liabilities in full) if certain conditions are met.
12: Nowadays these deposits are eligible towards MREL but authorities such as the SRB or the ECB are very reluctant to continue to include them in the future.
13 Both the Council and the Parliament texts include a grandfathering regime.

are eligible towards MREL but that might not be the case in the near future. To illustrate, nearly 40% of the eligible issuances performed by banks in the sample are governed by English law.

Shortfalls: total MREL-eligible debt and subordinated instruments

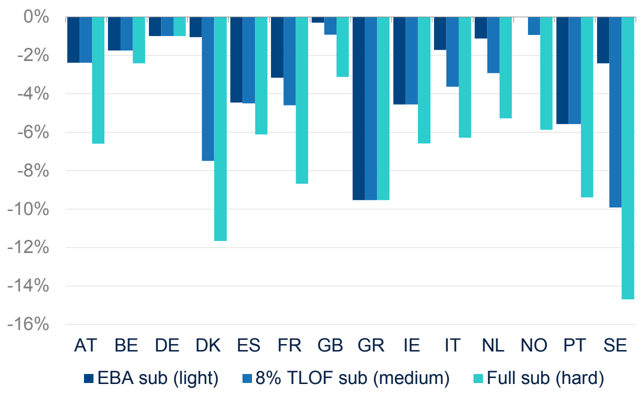
The subordination requirement considered in each scenario plays a critical role in the calculation of MREL shortfalls. Indeed, the results are highly divergent among the **light** (**€ 195 bn**), the **medium** (**€ 301 bn**) and the **hard** (full subordination) scenarios (**€ 526 bn**). The shortfalls are highly heterogeneous among banks and countries, derived from the fact that some financial systems show a greater issuance capacity of senior debt while others (mainly peripheral) show a stronger reliance on subordinated instruments (mainly regulatory capital) and deposits in their funding structure.

Figure 2a Shortfall of MREL-eligible instruments (€ bn) breakdown by country



Source: BBVA Research, considering consolidated capital instruments and MREL-eligible debt issued at the point of entry at the top of the group.

Figure 2b Shortfall of MREL-eligible instruments, pp of RWA, breakdown by country



Source: BBVA Research, considering consolidated capital instruments and MREL-eligible debt issued at the point of entry at the top of the group.

In absolute terms, the most significant shortfalls would be experienced in Spain (between € 61 bn and € 84 bn)[14], France (between € 61 bn and € 168 bn) and Italy (between € 17 bn and € 62 bn), see Figure 2a. However, in percentage points of risk-weighted assets, northern European countries would be the most affected (caused by low risk-weighted assets density). All in all, Greece (10% of RWAs), Portugal (6%-9%), Ireland (5%-7%) and Spain (4%-6%)[15] would present the highest shortfalls under the three scenarios (Figure 1b). Similarly, in percentage points of TLOF, the most affected countries would be Greece (8% of TLOF), Portugal (3%-6%), Ireland (2%-3%), Spain (2%-3%)[16] and Sweden (1%-3%).

The difference in MREL shortfalls under the light, the medium and the hard scenarios is explained by the subordinated debt shortfall[17] across the EU. In aggregate, subordinated debt shortfall varies from **€ 24 bn** under **the light scenario**, **€ 167 bn** under **the medium scenario** and **€ 526 bn** under **the hard scenario**. For the sample considered, subordinated debt shortfall is significant in France, Sweden and the Netherlands. Indeed, banks from

14, 15 and 16 The figures for Spain are to be treated cautiously as the two largest banks follow an MPE resolution strategy and their MREL will be set on a sub-consolidated basis only which will differ from the calculations in this note (on a consolidated basis because of limitations of public data).

17: Subordinated shortfall refers to the deficit of subordinated instruments (those ranking pari passu with senior non preferred/senior issued from a holding company or below).

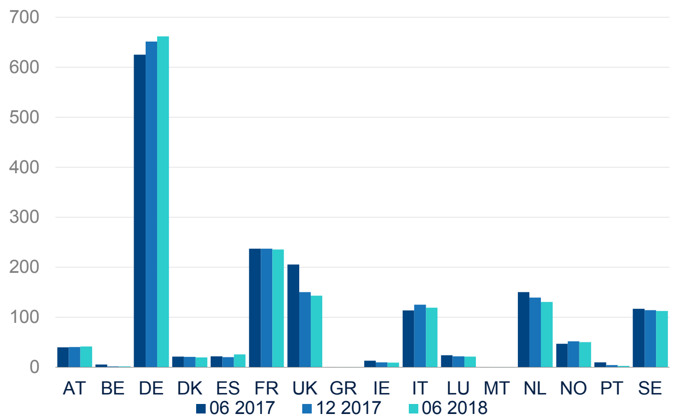
these countries would face subordinated debt shortfalls under the medium scenario of 3% to 10% of risk-weighted assets.

Germany is unaffected by the different subordination scenarios because it is the only country that has statutorily and retroactively subordinated its senior debt since 2017.

Getting ready for MREL: Evolution of eligible instruments across the EU, outstanding amounts

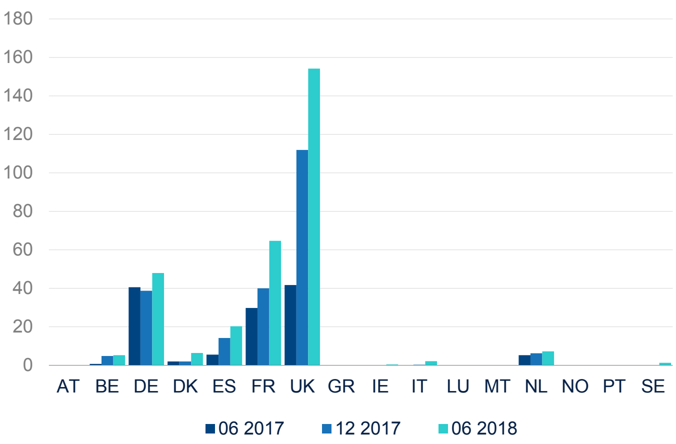
According to market data as of June 2018, European banks are building up their buffers of MREL-eligible debt, which have increased by 6% since June 2017. Among MREL-eligible debt, the most significant increase is observed in the outstanding balance of senior non-preferred or senior, which has increased by € 184 bn over the last year, mostly explained by the issuances performed by banks in the UK, France and Spain (Figure 3b).

Figure 3a Outstanding senior preferred, over 12-month remaining maturity (€ bn) evolution



Source: Bloomberg and BBVA Research

Figure 3b Outstanding senior non-preferred or senior, over 12-month remaining maturity (€ bn), evolution



Source: Bloomberg and BBVA Research

The European market of senior preferred debt is highly fragmented, with 74% of outstanding balance concentrated in Germany, France, UK and the Netherlands[18] (Figure 3a). Indeed, these countries face limited shortfalls of senior debt and are more affected by more stringent subordination scenarios. On the contrary, peripheral countries show a limited market activity with regards to senior preferred and senior non preferred issuances (with 10% and 7% of outstanding balance, respectively)[19], which explains the shortfalls calculated in the previous section. Traditionally, peripheral banking systems show a liability structure more dependent on subordinated instruments and deposits, with a limited amount of senior debt issued. This is also confirmed by the fact that they concentrate 23% of subordinated debt outstanding balance. This stronger position in subordinated debt markets, together with their reliance on capital instruments, explains the tight difference in calculated shortfalls between the light scenario and more stringent subordination scenarios. Lastly, CoCo and subordinated debt show annual increases of 5% and 2%, respectively. The subordination requirement is also relevant in the estimation of the cost of complying with MREL, because the return demanded by investors for issuances of subordinated instruments is substantially higher, as confirmed in the next section.

[18] Germany, France, UK and the Netherlands represent 66% of the assets of the sample considered as of December 2017.

[19] Peripheral countries represent 18% of the assets of the sample considered.

Heterogeneity in the management of MREL shortfalls: issuances and costs

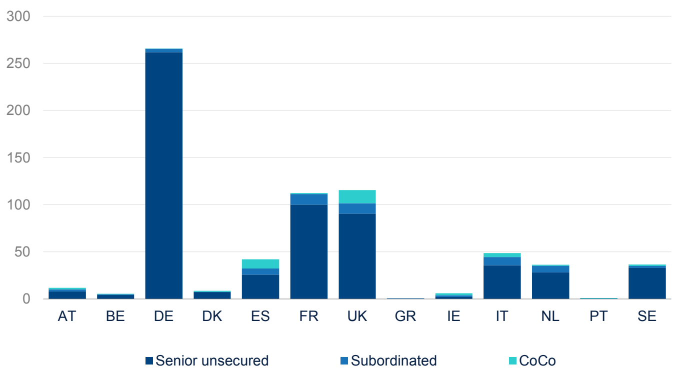
European banks have issued a non-negligible amount of senior debt, subordinated debt and CoCos in the period that ranges from January 2017 to March 2018. Peripheral banks have issued 14% of the total eligible debt issued in the period for the countries considered. In contrast, core countries have issued 62% of the total, which confirms the predominant position in bank-issued debt markets, raised in the previous section (58% of outstanding balance as of June 2018).

For each debt category, the distribution of the type of issuances across countries is also divergent. Thus, banks from peripheral countries only account for 11% of senior unsecured issuances, but they performed 31% and 44% of subordinated debt and CoCo issuances, respectively (Figure 4a). As noted in the shortfall section, they show a manageable shortfall of subordinated instruments due to their strong position in this market segment and due to the remarkable weight in peripheral systems' liabilities' structure.

Therefore, banks from core countries account for 67% of senior debt issuances and 44% and 13% of subordinated and CoCo issuances, respectively (Figure 4a). Thus, this liabilities' structure (more dependent on senior debt) involves that lower allowance of senior debt, or more stringent subordination scenarios, lead to higher subordinated instruments' shortfall. Indeed, banks from countries such as France or the Netherlands would experience non-negligible subordinated instruments' shortfall.

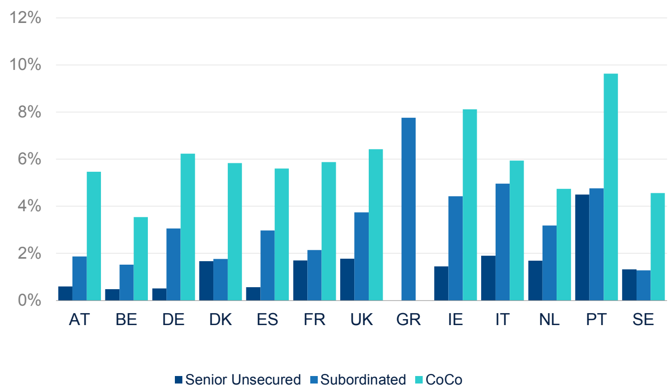
Another key element regarding the capacity of complying with MREL is the cost of the instruments. The weighted average rate at the moment of the issuance demanded by investors is 1.1% for senior unsecured debt, 3.5% for subordinated debt and 5.5% for CoCos (Figure 4b). On one hand, banks from peripheral countries face issuance costs above the average which implies difficulties in managing with their high MREL shortfalls. On the other hand, banks from core countries display issuance costs below the average and a deep market activity, showing a strong capacity of complying with MREL. However, higher subordination requirements might erode their profitability.

Figure 4a Issuances of MREL-eligible debt, breakdown by country (€ bn)



Source: Bloomberg and BBVA Research calculations. Note: issuances performed in the period ranging from January 2017 and March 2018

Figure 4b Average rate on issuance, breakdown by country, (%)



Source: Bloomberg and BBVA Research calculations. Note: issuances performed in the period ranging from January 2017 and March 2018

Conclusions

- Based on data from end 2017 we have measured the impact of MREL under three different scenarios with different levels of subordination for a heterogeneous sample of 63 European banks. The results show that the overall deficit of MREL depends critically on subordination: **€ 195 bn** under **the subordination recommended by the EBA** (lightest scenario), **€ 301 bn** under the **Council's compromise text subordination** (medium scenario) and **€ 526 bn** under a **full subordination** scenario (hard), which is the scenario where banks would have to comply with MREL with subordinated liabilities only. Similarly, subordinated instruments shortfall would be **€ 24 bn** under the light scenario, **€ 167 bn** under the medium scenario and **€ 526 bn** under the hard scenario.

- **Banks from peripheral countries** would be the most affected as they display the largest MREL shortfalls as well as the higher costs of MREL eligible debt.

- Banks from **core countries** would be in a better position to comply with MREL as they manage limited shortfalls (albeit higher subordinated instruments shortfalls) and lower costs for their issuances.

- An analysis of the market confirms these findings as markets for MREL eligible debt seem to be more developed and display higher levels of activity in core countries.

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